

**COORDINATED ISSUE
DATA PROCESSING INDUSTRY
CAPITALIZATION OF LEASE RELATED EXPENSES**

ISSUE

Whether costs directly associated with the acquisition of lease contracts on equipment and costs associated with preparing the equipment for use should be capitalized under section 263¹ and amortized over the life of the lease.

CONCLUSION

Where the leases are considered to be capital assets the costs associated with lease acquisition and costs associated with preparing the equipment for use should be capitalized under section 263 and amortized over the life of the lease.

FACTS

Within the data processing industry, manufacturers often lease and service their manufactured equipment. The leasing contracts typically provide for fixed terms ranging for more than one year and may not be terminated prior to the lease term without a substantial penalty. Some of the leases are for less than one year, or are for an indeterminable period because, for example, they are renewable, but often last for more than one year with renewals. The leases either continue to generate revenue for the full lease term or are discontinued by having a purchase option exercised by the lessee, or by payment of a substantial termination charge.

In connection with such leases the manufacturers incur a variety of costs, such as: installation costs; commissions and bonuses to sales personnel for securing the lease; costs to develop software for the lessee; system application and support costs; and expenses for customer training, site planning, etc.

¹Unless otherwise noted, all code references contained herein are to the Internal Revenue Code of 1986.

LAW AND ANALYSIS

Generally, section 162 allows a current deduction for ordinary and necessary business expenses incurred in carrying on a business. Section 263 disallows deductions for amounts paid for the acquisition or creation of a capital asset. Usually, the costs of assets or benefits that last beyond the taxable year must be capitalized. (See, Treas. Reg. § 1.461-1(a)).

Because these leases either continue to generate revenue for the full lease term or are discontinued by having a purchase option exercised by the lessee, or by payment of a substantial termination charge they are valuable assets. If the leases are for more than one year, they are capital assets. Shulter v. United States, 470 F.2d 1143 (10th Cir. 1982); Munger v. Commissioner, 14 T.C. 1236 (1950). As such, section 263(a) requires capitalization of associated costs.

Where the lease, on its face, appears to be for a term of one year or less, or is for an indeterminable period because, for example, it is subject to renewal, the cost associated with such lease may, nevertheless, be capitalizable if the lease meets the long-term benefit test espoused by the Supreme Court in Indopco, Inc. v. Commissioner, U.S., 112 S. Ct. 1039 (1992), aff'd sub nom, National Starch & Chemical Corp. v. Commissioner, 918 F.2d 426 (3d Cir. 1990). It is recommended that the industry specialist be contacted if such a lease is discovered.

In Rev. Rul. 68-561, 1968-2 C.B. 117, a public utility awarded cash allowances to builders, contractors, and owners of buildings for either the construction of all gas homes or the conversion of other systems to gas. Other expenses incurred in connection with the campaign were salaries paid to the utility's representatives and allowances to builders and apartment house owners who advertised their property making reference to gas, and direct advertising costs of the sales campaign. The revenue ruling holds that the cash allowances were capitalizable since they secured a benefit to taxpayer (the increased sales of taxpayer's gas) that could reasonably have value extending beyond the year paid or incurred. See also, Louisiana Land & Exploration Co. v. Commissioner, 7 T.C. 507 (1946), aff'd, 161 F.2d 842 (5th Cir. 1947); Fall River Gas Appliance Co. v. Commissioner, 42 T.C. 850 (1964); Houston Natural Gas Corp. v. Commissioner, 90 F.2d 814 (4th Cir. 1937), cert. denied, 302 U.S. 722 (1937). Salaries and advertising were held to be less directly and significantly productive of intangible assets having a value extending beyond the years in which they were paid or incurred, and thus were allowable as ordinary and necessary business expenses under section 162.

The Service has traditionally allowed recurring commissions and bonuses as an ordinary and necessary business deduction under section 162. However, when the commission or bonus is directly associated with a capital asset, the capitalization

provisions override the deduction provisions of the Code. In Rev. Rul. 69- 331, 1969-1 C.B. 87, a taxpayer was engaged in the sale and distribution of gas and leased automatic hot water heaters to its customers. The term of each lease was 5 years. The taxpayer paid bonuses and commissions to its own company salesmen and to dealers and plumbing contractors for securing customers for its rental heaters. The revenue ruling holds that the bonuses and commissions are capital expenditures amortizable over the term of the leases. Rev. Rul. 68-561 was distinguished on the basis that the expenditures for salaries and advertising that were held to be deductible under section 162 were less directly associated with the production of assets having a value extending beyond the taxable year in which the expenditures were paid or incurred. Both these revenue rulings provide that only bonuses and commissions directly and significantly productive of the lease need be capitalized.

Under facts similar to those in Rev. Rul. 69-331, the taxpayer in Fall River Gas Appliance Co., Inc. v. Commissioner, 349 F.2d 515 (1st Cir. 1965), aff'd 42 T.C. 850 (1964), was engaged in the sale and distribution of gas and leased automatic hot water heaters to its customers. Fall River deducted, as an ordinary and necessary business expense, the cost of installing the hot water heaters. In affirming the Tax Court's ruling that the installation costs must be capitalized, the Fifth Circuit found that Fall River clearly anticipated that the overall duration of the lease would produce rental income and an increase in the consumption of gas. Having found that the installations had a useful life of twelve years, the court concluded that Fall River was required to capitalize the installation costs.

Where an expense is directly associated with the acquisition of a lease, the capitalization provisions override the deduction provisions of the Code. Therefore, an expenditure that would ordinarily be deductible must nonetheless be capitalized. Ellis Banking Corporation v. Commissioner, 688 F.2d. 1376 (11th Cir. 1982). With regard to bonuses, commissions and installation costs, these expenses, when directly associated with the acquisition of a lease, are nondeductible capital expenses. Other directly related expenses, such as costs to develop software for the lessee; system application and support costs; and expenses for customer training and site planning may be subject to the capitalization rules, depending on the facts and circumstances of the particular taxpayer.